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US: stronger growth, higher rates, more uncertainty

- We have revised our forecasts (see *Forecasts at a glance*, 25 November 2016 for prior forecasts) and project significantly stronger economic growth, faster Fed rate increases and higher bond yields, based on our assessment that Congress will enact a modified version of the fiscal and tax reforms that President-elect Trump will propose.
- Real GDP is projected to grow by 2.4% in 2017 and 2.9% in 2018, up from 2.2% and 2.0%, respectively. Inflation measured by the core personal consumption expenditure (PCE) deflator is projected to rise by 1.9% in 2017, similar to our earlier forecast of 1.8%, but then increase to 2.2% by Q4 2018, above the Fed's longer-run 2% target.
- Business investment and government purchases (infrastructure and defense spending) are expected to be the largest contributors to the stronger growth with a moderate pick-up in consumption. The trade deficit is expected to widen and subtract domestic production.
- The Fed is now projected to raise rates three times in 2017 following its anticipated 25bp rise in December 2016, lifting its funds rate to 1.5% by year-end 2017. We anticipate two more rate increases in 2018.
- Bond yields have already risen significantly in response to expected stronger growth and we project they will rise further, with 10-year Treasury bond yields at 2.8% and 3.3% at year-end 2017 and 2018, respectively.
- This revised forecast is based on key assumptions about what the Trump administration will propose and what Congress will enact, the timing of the implementation of the new spending and tax initiatives, and how households and businesses will respond to the reforms. Risks abound, particularly in trade policies. As such, these forecasts involve many uncertainties.

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Mickey D. Levy
Chief Economist US, Americas and Asia
+1 646 445 4842
mickey.levy@berenberg-us.com

Roiana Reid
Economist
+1 646 445 4865
roiana.reid@berenberg-us.com

Our revised economic projections reflect the very high probability that Congress will enact key portions of the Trump administration's fiscal reform proposals. We expect Congress to push back on some of Trump's proposed legislation in order to constrain budget deficit increases, resulting in fiscal policies that are more moderate than those put forward during the presidential campaign. Businesses and households are projected to respond positively. Inflation is projected to rise above the Fed's 2% longer-run target, even though it will be constrained by a strong US dollar. The Fed is expected to quicken its pace of interest rate normalization in response to the stronger growth stemming from the fiscal reforms.

Fiscal and economic reforms are expected to include the following.

- Corporate tax reform, featuring lower marginal rates and a broader base against which taxes are assessed, as well as some tax code simplification. Most prominently, businesses will be allowed to expense investment in equipment and software, but deduction of net interest costs will be reduced. The Trump transition team is considering assessing taxes on imports and not exports, but this issue has not been resolved.
- There will be modest tax rate reductions on individual incomes accompanied by reduced value of deductions for higher income tax filers. Deficit considerations likely will limit the magnitude of the individual income tax cuts.
- A sizeable infrastructure initiative will be enacted that will provide increases in spending over numerous years. There will be modest spending increases for defense and national security.
- Easing of selected regulations that have exerted excessive burdens on businesses and labor market mobility. New legislation will require Congress to conduct cost-benefit analyses of new regulations that are deemed to be costly to the economy.

These policies are projected to lift economic growth through a combination of: 1) increased deficit spending on infrastructure and defense; 2) economic responses by businesses and households to fiscal and regulatory reforms; and 3) increased economic efficiencies resulting from the easing of burdensome regulations. Standard neo-Keynesian models that measure fiscal stimulus in terms of changes in cyclically adjusted budget deficits will significantly underestimate the economic impacts of the tax and economic reforms.

The risks to our forecast cut both ways: on the downside, the potentially negative effects of trade policies and related uncertainties could depress trade flows and business confidence, and raise prices of consumer products; on the other hand, if the fiscally conservative Congress does not push back on tax cuts and spending proposals, and enacts excessive stimulus, then economic growth will accelerate materially. This could overheat the economy, which would elicit more aggressive Fed rate increases that would generate a subsequent reversal.

The backdrop for Trump's proposed fiscal reform

In the years leading up to the election, economic growth was disappointingly slow, with consumption and housing advancing firmly but business investment and exports weak. Sustained low productivity gains and disappointing investment had depressed estimates of potential growth to between 1.8% (Fed) and 2.0% (Congressional Budget Office (CBO)) from 2.6% in 2007. The unemployment rate had fallen below 5%, reflecting a combination of healthy employment growth and lower labor force participation, but wage gains have just started to pick up. The Fed's monetary policy has been widely acknowledged as an ineffective economic stimulant, and both sides of the political aisle have been calling for a shift in fiscal policy.

In this context, presidential candidate Clinton proposed higher government spending and taxes and more government reforms, while presidential candidate Trump proposed lower taxes, more spending for infrastructure and defense, less spending on other items, and fewer regulations. Both candidates were stridently against trade agreements and highlighted the negatives of international trade.

More specifically, the Trump campaign election platform involved large individual tax cuts; corporate tax reform with lower rates and a broader base but with insufficient detail on how the base would be broadened; large spending increases on infrastructure, defense and national security and medical care for Veterans, alongside savings in other parts of the budget that were largely unspecified; and dramatically higher trade barriers on China, Mexico and other large US trading partners.

Trump's economic platform had two broad objectives: to stimulate the domestic economy, particularly business investment that has languished despite the extraordinarily low bond yields and costs of capital; and to reduce the US trade imbalances and restore jobs that were presumed to have been lost as a consequence of international trade.

This economic platform had two clear weaknesses: fiscal proposals were missing critical detail and seemed to add up to significantly larger budget deficits; proposed large barriers to trade could damage US trade with some of its major trading partners.

From campaign platform and promises to legislation

Like many newly elected presidents, Trump will lead with tax reform legislation. This is typical of new presidents during their "honeymoon" periods. Historically, tax reform is proposed early into new administrations and readily enacted – with modifications – by Congress. Recently, this has been true of Presidents Reagan (1981), Clinton (1993), Bush (2001) and Obama (2009). On spending initiatives, both Republicans and Democrats favor more infrastructure spending, so Congress likely will be eager to work with the Trump administration on this initiative. The biggest controversy will center on the magnitude of budget deficit increases and how higher spending will be financed. On trade policy, mainstream Republicans tend to favor international trade (and trade agreements) and support low barriers to trade, in contrast to the higher barriers proposed by Trump. This difference must first be ironed out within the Trump transition team – some of Trump's leading economic advisors favor free trade along with pro-growth domestic reforms, while several advocate higher barriers to trade – and then in negotiations with Congress. To date, the Republican-controlled Congress has not developed a policy position on international trade.

Although key Republican leaders – most notably Speaker of the House Paul Ryan – opposed Trump's ascendancy to the presidency, they are now working closely with key members of the Trump transition team toward formulating policies, particularly on tax reform. Under Congressman Ryan's direction, in the last year Republican leaders in Congress have developed position papers on six key issues (the economy, tax reform, poverty, health care, national security and the Constitution), and Trump's economic advisors are now using the position paper on tax policy developed by the Congressional Republican leadership as a basis for its own proposal (*A better way: our vision for a confident America, tax,* June 24, 2016, better.gov).

While Republican leaders favor pro-growth tax reforms, they all share another characteristic: they are fiscal conservatives and are very concerned about projections of dramatic increases in deficits and debt. While so much attention is now being paid to who Trump appoints to his transition team, an equally important issue for the fiscal and economic policies that are actually enacted is how Congress will respond to Trump's economic proposals; that is, will Congress tilt toward big tax cuts and spending increases or toward a more toned-down fiscal package that emphasizes reform while constraining the magnitude of deficit increases? Under current law, the Federal budget deficit and publicly held Federal debt are expected to increase in coming years (see Charts 1 and 2).

We expect Congress to push back on proposals that would result in too large of an increase in deficits. Amid myriad uncertainties about the policy deliberations currently unfolding, our revised projections of economic performance, inflation and Fed policy and bond yields reflect our assessment of legislation that is most likely to be enacted, private sector responses and feedback effects.

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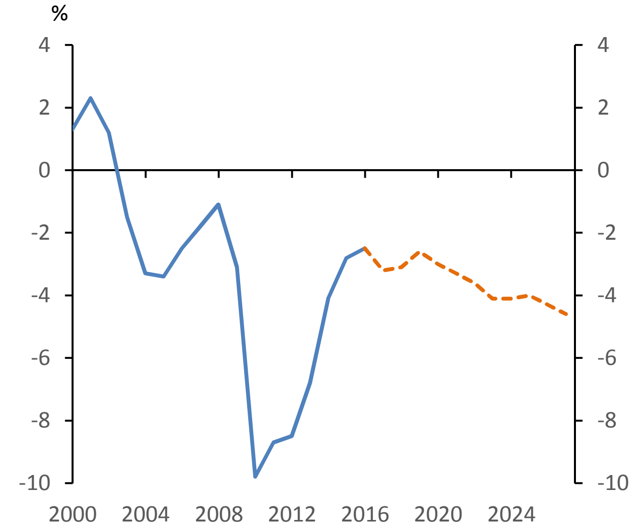
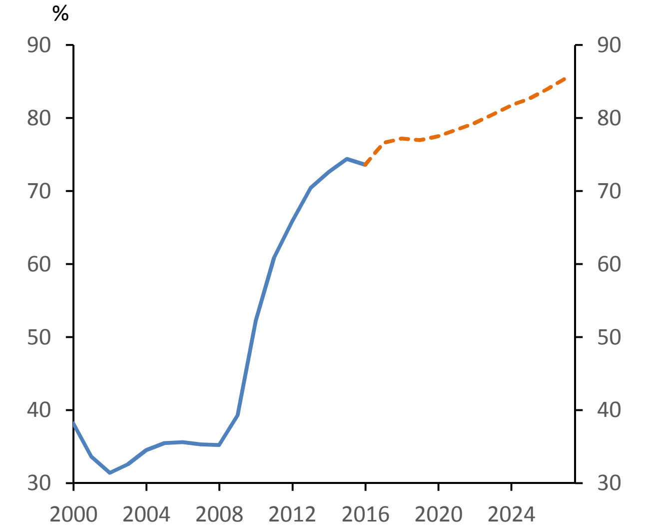
Chart 1: CBO's baseline estimate of Federal Budget Deficit as % of GDP



Source: Congressional Budget Office, Berenberg Capital Markets and Haver Analytics

Chart 2: CBO's baseline estimate of Federal debt held by the public as % of GDP



Source: Congressional Budget Office, Berenberg Capital Markets and Haver Analytics

Corporate tax reform

The US's current corporate marginal tax rate is 35% – the highest of all advanced economies. Trump wants to reduce it to 15%, but our assessment is that at most it will be lowered to the 20% proposed in *A better way*, or to 25%, which would still represent a sizeable reduction.

- It is likely to include a sharp cutback in the deductibility of business net interest expense aimed at evening out the tax treatment of debt and equity financing.
- Businesses would be allowed to expense investment in equipment and software (that is, deduct the full cost of such investments).
- There would be a one-time tax of 10% on repatriated cash held overseas by US businesses; note that some of the largest cash-rich businesses have sizeable production and sales overseas, so not all of their cash held overseas will be subject to this one-time tax.
- There will be other changes to deductions, deferrals, exemptions and credits aimed at closing tax loopholes and broadening the corporate income tax base.
- The Trump transition team is considering assessing a tax on imports with no tax on exports. Its intent is to discourage imports and encourage exports, but this approach and its possible enactment remain uncertain.
- These tax reform provisions would apply to subchapter S corporations.

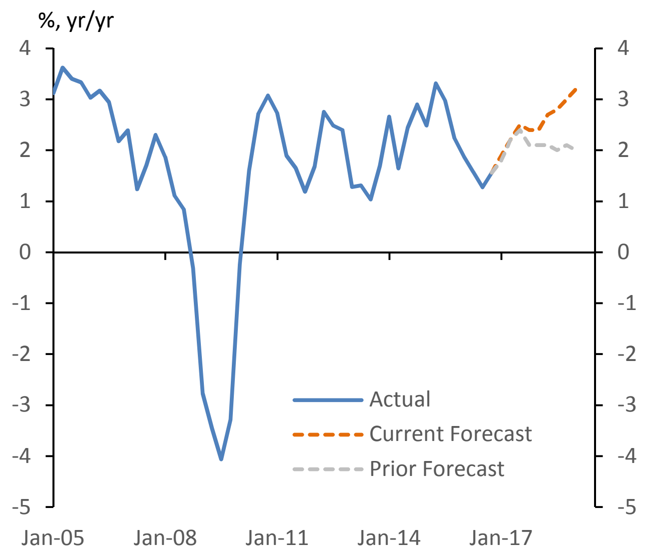
The current tax system is truly flawed. The marginal tax rate is very high, but the effective rate – the portion of income corporations actually pay in taxes – is relatively low, reflecting a tax base that has been eroded by a complex web of deductions and deferrals. The tax system contributes to economic inefficiencies and distorted behavior. Along with an equally complex web of burdensome regulations, the corporate tax system is considered one of the key factors that constrain business investment and expansion plans. It is noteworthy that the Fed's successful efforts to lower bond yields and costs of capital have not stimulated business fixed investment. Instead, businesses have taken advantage of the strikingly low after-tax costs of borrowing by issuing bonds and buying back shares (*Resetting Fed policy*, October 7, 2016).

Key provisions in Trump's tax reform are designed to boost investment spending and encourage expansion and hiring. Business responses to this reform are projected to be moderately positive. The critical issue in our forecast is the extent to which reform will lift business confidence and lead companies toward more expansive investment plans.

We understand that corporate tax law is very complex but nevertheless anticipate an ambitious Trump administration and Congress will enact corporate tax reform in summer 2017. Its date of implementation is uncertain—major policy changes will not be made retroactive; they could be made effective immediately or at the beginning of fiscal year 2018 (October 1, 2017). The timing of implementation may generate a wide swing in the quarter-to-quarter growth rates. **We project business fixed investment growth to nearly double in 2018 to 6.3% from our earlier forecast and its recent rate of growth of 3.1% (see Chart 4).** While this boost may seem large, it is small compared to responses to prior tax reforms, such as President Reagan's tax cuts of 1981. The boost to business investment in 2017 depends on the timing of enactment and implementation of reform.

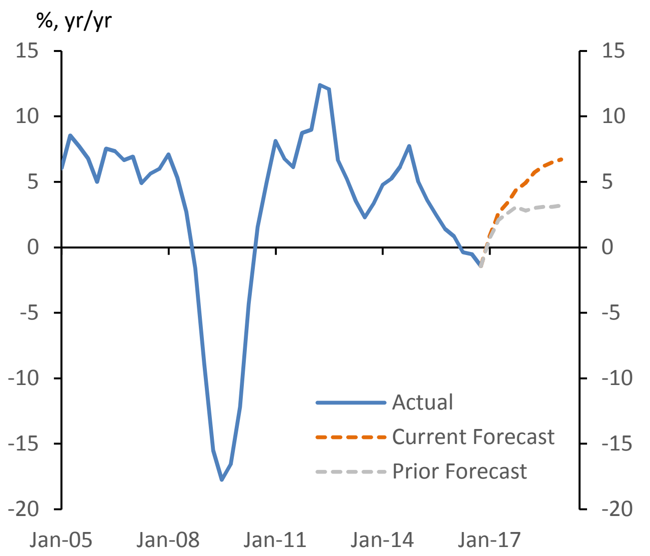
In general, businesses are expected to benefit from the lower marginal rates and the expensing of new investment in equipment and software. More highly leveraged businesses would face higher taxes stemming from the reduced value of deductibility of interest expenses. The repatriation of cash from overseas would generate a one-time increase in federal tax receipts and lead businesses to change their capital structures, depending on their circumstances. It may also support a stronger US dollar and cause temporary turmoil in overseas short-term funding markets. If taxes are assessed on imports but not exports, as is currently being considered, companies that rely more heavily on imports may face higher after-tax operating expenses, while those that rely more on exports will benefit. It is noteworthy that even though the general trend in the Trump administration will be toward fewer regulatory burdens, a complex web of regulations and government mandated expenses on the Federal, state and local levels will continue to be a burden on businesses and weigh on their expansion decisions.

Chart 3: Real GDP, actual and forecasts



Source: Bureau of Economic Analysis, Berenberg Capital Markets and Haver Analytics

Chart 4: Real business fixed investment, actual and forecasts



Source: Bureau of Economic Analysis, Berenberg Capital Markets and Haver Analytics

Infrastructure and defense/national security spending initiatives

In recent years, spending on infrastructure and defense has fallen as a share of GDP. While the need for significant increases in spending to upgrade the nation's infrastructure is widely acknowledged, the debate about the defense budget centers on reallocating resources to modernize national security as much as it does on how much to increase spending.

The biggest issues for infrastructure spending will be budget deficit constraints, how the increased spending will be financed and how projects will be chosen and administered. During the presidential campaign, Trump argued that there would be significant savings through spending cuts in other government programs. However, he also called for increases in defense spending and no cuts in Social Security to current beneficiaries. Excluding spending on entitlement programs (largely Social Security, Medicare and

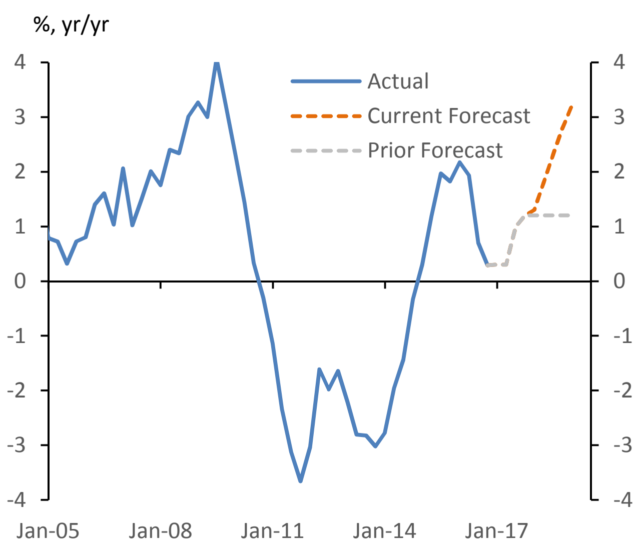
Medicaid), defense and net interest costs, the rest of the budget outlays (so-called non-defense discretionary spending) provide an insufficient basis for large cuts. New user fees may be introduced and there may be heavier reliance on state and local government financing as well as public-private partnerships.

Several of Trump's economic advisors have proposed public-private partnerships that would finance infrastructure spending through large tax credits to corporations that invest in infrastructure projects. However, it is noteworthy that these credits reduce the government's tax receipts, which indirectly contributes to deficit spending. The newly created jobs will boost personal income and tax receipts, providing a partial offset. Moreover, while some infrastructure projects will be attractive investments for select corporations, many of these projects are public goods that the government (Federal, state or local) should properly provide and will not be attractive investments to private corporations. These thorny financing obstacles have not yet been resolved.

Nevertheless, our forecast anticipates that popular support will lead to enactment of a large increase in infrastructure spending. The headline increase in spending as measured in the CBO's 10-year budget projections will be strikingly large – likely around $1trn. But that spending increase will be spread over numerous years, with a portion allocated to longer-term projects that will add to government purchases and GDP throughout the projection period. This will contrast sharply with President Obama's infrastructure spending program of 2009, the aim of which was to spend the money as quickly as possible (on "shovel-ready projects") in order to stimulate the economy out of recession.

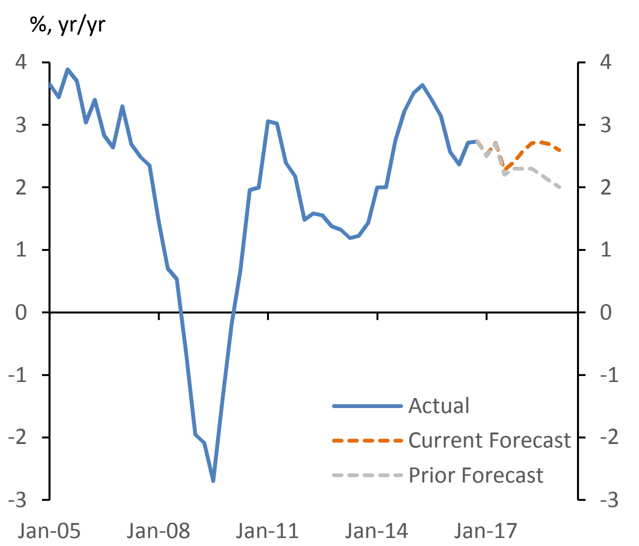
We estimate that infrastructure increases will add a modest amount to GDP growth in 2017 and roughly 0.4-0.5% per year to GDP beginning in 2018. This is similar to the increase in GDP provided by President Reagan's defense rebuilding in the early 1980s. This will add to relatively high wage private sector jobs that will boost disposable income (the government contracts and subcontracts for infrastructure projects must abide by the Davis-Bacon and Related Acts that stipulates minimums on wages equal to union wages and generous overtime, and will largely involve unionized workers). As we have described in our prior reports, while much of the infrastructure spending will be on upgrading roads, bridges and other public facilities, there will be ample spending on the electrical grid, air traffic control systems, oil and gas pipelines, ports, cyber security and bio-terrorism/disease control – all of which are critical components of infrastructure in modern society (*US infrastructure spending – a roadmap for Thinking Broadly*, October 24, 2016).

Chart 5: Real government consumption and investment, actual and forecasts



Source: Bureau of Economic Analysis, Berenberg Capital Markets and Haver Analytics

Chart 6: Real private consumption, actual and forecasts



Source: Source: Bureau of Economic Analysis, Berenberg Capital Markets and Haver Analytics

Even if the increase in infrastructure (and defense) spending is fully offset by spending cuts in other government programs or tax increases, it directly adds to GDP and stimulates economic growth (see Chart 5).

Individual income taxes

While Trump proposed large cuts in individual income taxes on the campaign trail, Congress's concerns about budget deficits will likely lead it to limit in magnitude. The likely result will be modest cuts in marginal income tax rates, largely for middle and lower income households, and reduced value of deductions. **As a result of this budget-constrained assessment of income tax policy changes, we forecast modest increases in consumption growth (see Chart 6).**

A risk to our forecast is that the Trump administration proposes large cuts in individual income taxes and Congress enacts them without imposing budget constraints. This could lead to a temporarily faster-than-projected consumption and economic growth. Based on the starting point of an aging economic expansion and sub-5% unemployment rate, this scenario would run the high risk of overheating the economy with the undesired effect of rising inflation. This would force the Fed into faster rate increases, which would run the risk of a subsequent reversal of the economic strength.

Regulatory policies

We anticipate that the Trump administration and Congress will ease some of the most burdensome regulations in both the financial and non-financial sectors and try to reverse the tide of new regulations costly to the economy.

We expect new legislation will be enacted that requires Congress to conduct cost-benefit analyses of all newly proposed regulations that are deemed to be costly to the economy, and to incorporate these analyses into budget projections. Whether these analyses are conducted within a new unit of the CBO or under another congressional agency is uncertain at this time.

The most burdensome regulations in labor markets, business, the environment and energy are expected to receive close scrutiny. However, while the general thrust of the Trump administration will be to ease the most onerous and unproductive regulations, the web is very complex and it is uncertain how many regulations can be unwound. Nevertheless, the general thrust away from the recent mounting reliance on regulatory burdens that were perceived to be anti-business may lift business confidence and reduce uncertainties, which may stimulate expansion plans, including more investment and hiring.

Current initiatives pending in Congress to reform commercial banking and the Fed have a higher probability of being enacted now that they are supported by the Trump administration. **Pending legislation authored by Jeb Hensarling, Chairman of the House Financial Services Committee (The Financial Choice Act) would greatly diminish the regulatory burdens of the Dodd-Frank Act for banks that increase their capital to at least 10% of total assets (the legislation would eliminate Basel risk weightings so that capital adequacy would be measured against all assets rather than a measure of risk-weighted assets).** This would effectively impose leverage caps on banks. Medium-sized and smaller banks would likely benefit the most from such legislation. Banks facing lower regulatory burdens would more readily increase their lending. The increase in credit availability may stimulate business expansion and economic growth.

Trade policy

Trade policy is a major wildcard in the economic outlook, and it poses downside risks. The Trump transition team is in the process of sorting out its trade policies. One camp of economic advisors favors significantly higher barriers to trade, particularly for some of the US's largest trading partners with which it has large bi-lateral trade deficits, including Mexico and China. If pursued, this would be unfortunate. It potentially would dampen economic performance and would not protect those US workers as intended. Other economic advisors to Trump, most notably pro-growth supply-siders, favor open borders and fewer trade barriers.

In part, this issue may be resolved through corporate tax policy: congressional Republicans have proposed taxing goods and services imported into the US and not taxing exports, thereby discouraging imports and encouraging exports and production in the US. Whether this is proposed by the Trump administration and enacted by Congress is highly uncertain. Some have argued that this may not be permissible under international law. Moreover, it would have many ramifications for operating costs and the business decisions of US corporations, and any proposal would need to be vetted in more detail.

Besides, proposals that must be enacted by Congress, such as tariffs and quotas (these are under the mandate of the House Ways and Means and Senate Finance Committees), the Trump administration may erect obstacles to international trade of specific goods and services through various regulatory avenues. While such initiatives may ease the direct burdens of trade on specific US companies and workers, they may inhibit growth on net and tarnish trade relations with key partners.

Identifying China as a currency manipulator would have little direct impact and would be largely symbolic in nature, signaling that the Trump administration will aggressively address trade practices that it perceives to be "unfair". It is noteworthy that China currently does not fully fit the US Treasury's definition of a currency manipulator. China's leaders may consider such a move by the Trump administration as a serious insult. This could usher in tense diplomatic and trade relations, with various types of retaliation and unknown consequences.

Stronger economic domestic demand, particularly if driven by a pick-up in capital spending, is projected to widen the US trade deficit and reduce the growth of domestic production (GDP) relative to domestic demand.

We are concerned that the Trump administration may pursue misguided initiatives that inhibit international trade in ways that harm economic performance. However, lacking sufficient detail, it is uncertain how policy-induced changes in trade flows may affect the US's net export deficit.

Fed policy and financial market responses

The Fed is projected to quicken its pace of raising interest rates in response to stronger economic growth stemming from fiscal reform and bond yields are expected to rise further. Following its widely anticipated rate increase in December, the Fed is now projected to raise rates three times in 2017, lifting the 2017 year-end target to 1.25-1.5%. We project two additional rate increases for 2018, raising the policy rate to 2.0%. Recently, 10-year US Treasury bond yields have increased from 1.7% to 2.3%, largely in response to anticipated stronger growth and higher inflation. Our year-end projections have been increased to 2.8% for 2017 and 3.3% for 2018, reflecting anticipated stronger economic growth, quicker Fed rate hikes and heightened sensitivity to signs of rising inflation. Markets will also be worried about the pending transition at the Fed at the end of Janet Yellen's term as chair in February 2018.

Presently, monetary policy remains excessively easy even though the Fed has largely achieved its employment and inflation mandates. Besides its bloated balance sheet, the real Fed funds rate is roughly -1.25%, far below its 1% estimate of the longer-run real natural rate of interest (so-called r* is the rate consistent with the economy growing along its potential path with stable 2% inflation). The median estimate of the appropriate longer-run Fed funds rate by Federal Open Market Committee (FOMC) members is 3%, while the Fed's inflation target is 2%. The Fed acknowledges the need to raise rates and that monetary policy has lost its stimulative punch. Fed members are becoming increasingly worried that its easy policies are generating mounting economic and financial distortions that raise risks to stability. Despite this, the Fed has continued to recommend very gradual rate increases, concerned primarily that rate increases may jar financial markets.

Fiscal reform and strong growth are game-changers that will change the Fed's conduct of monetary policy: Vice Chairman Stanley Fischer has already discussed Fed estimates of how fiscal stimulus (measured as changes in either taxes or government spending as a percent of GDP) would raise real interest rates. Stronger economic growth and enactment of fiscal reform would lead the Fed to move forward its rate increases. Moreover, amid stronger growth, the Fed will be much more sensitive to signs of rising inflation. Rising wages would fit into that category. Sustained stronger growth of the economy and business investment would lead the Fed to consider raising its estimate of the appropriate longer-run Fed funds rate.

Bond yields remain low compared to historical averages in market and inflation-adjusted terms, even with their recent increases. If inflation stays relatively low and rises only modestly, as we expect (it will be constrained in part by the stronger US dollar), bond yields will increase but by less than the Fed funds rate and the yield curve will flatten.

The US dollar is expected to remain strong, supported by a number of factors related to enactment of pro-growth fiscal and regulatory reforms, including stronger economic growth and faster Fed rate increases.

Our assessment is the stock market rally in response to Trump's victory and Republicans maintaining control of Congress is a valid forecast of stronger growth. However, in the past year the trajectory of profits has been slightly down and price/earnings multiples have increased. If, as we expect, the Fed quickens its pace of rate increases and bond yields rise further, the stock market must rely on support from rising profits. Our projected pick-ups in economic growth and capital spending are expected to breathe new life into actual and expected profits. However, this assessment involves many of the same risks in the economic forecast. If policies go off-track (for example, trade policy) and the economy stalls, then markets will correct down.

Observations on economic responses and feedback effects

Following years of disappointingly slow economic growth, diminished estimates of potential future growth and excessive reliance on the Fed's monetary policy to address growth-inhibiting factors that are beyond its scope, Trump's leading economic advisors are attempting to boost growth and lift potential. Their blueprint is the economic reforms of the Reagan presidency that generated strikingly strong economic performance with rapid GDP growth and job creation.

The expected enactment of pro-growth fiscal and economic reforms leads us to raise our economic forecast, but we caution against expecting the same magnitude of economic responses as occurred during the Reagan era. It was truly a different era: in 1981, when President Reagan entered office, the economy was in the middle of two back-to-back recessions, the unemployment rate was 7.5% and rising (it would rise to over 10% in fall 1982), CPI inflation was 11.8%, the federal funds rate was 19% and 10-year Treasury bonds yields were 12.5%. Congress enacted the Economic Recovery Tax Act of 1981 in August. The economy grew modestly in 1981, went back into recession in 1982 and then began to surge, driven by business investment. P/Es hit a low, below 10%, in mid-1982. In dramatic fashion, by the end of 1983, inflation had fallen to 3.8%, the Fed funds rate to 9.7%, and the long-sustained appreciation in stocks and bonds had just begun.

The present situation is far different: the economy has been expanding for 7.5 years, the unemployment rate is sub-5%, and the Fed has kept its policy rate below inflation and has flooded financial markets with liquidity. The government's debt is dramatically higher than during the Reagan era and a critical difference is that the current structure and magnitude of entitlement spending programs (particularly Social Security, Medicare and Medicaid) preclude the government's ability to grow its way to reasonably low debt levels.

Despite this qualification, policy reforms – if properly enacted – are a welcome relief to the recent business-as-usual policies that were eroding confidence and contributing to downward revisions of potential growth.

Regarding economic feedback effects, even if the Fed raises rates faster along the path we project, monetary policy would remain accommodative, with a negative real Fed funds rate through the projection period and excess liquidity in the financial system. History shows that, during economic expansions, growth is little affected when the Fed increases rates following periods of monetary ease.

A stronger US dollar would dampen US export growth compared to what it would be otherwise but, as noted above, by far the bigger risks to the US economic outlook are policy mistakes on international trade. It is noteworthy that export growth remained strong in the 1980s as the US dollar appreciated dramatically and remained firm during the second half of the 1990s in the face of a stronger currency.

The important role of the CBO's budget scorekeeping

The CBO likely will be in the center of controversy about the budgetary impacts and merits of key policy proposals, particularly since Republican leaders in Congress have to balance between their wish for tax reform and low deficits. The CBO is Congress's official budget scorekeeper, and fiscal deliberations between the administration and congressional leaders tend to focus on the CBO's estimates.

The CBO's 10-year budget projections of the impacts of proposed legislation typically use "static scorekeeping" that reflects microeconomic responses to policy changes rather than "dynamic scorekeeping" in which its estimates macroeconomic responses to the policy changes.

Critically important to the looming fiscal policy deliberations – even if the CBO uses dynamic scorekeeping to estimate the budgetary effects of policy changes – is that Trump's supply-side economic advisors argue for much larger business and household responses to tax and economic reforms than are implicit in the CBO's economic models. The differences between budget estimates methodologies are likely to be very large.

These differences are bound to stir controversy about the merits and budgetary effects of the proposals. This will generate bumps along the road to enactment. Our forecasts are based on the expectation that Congress will enact most of the Trump administration's proposals for corporate tax reform and infrastructure spending, but will limit the magnitude of individual tax cuts because of concerns about budget deficits.

Please see updated US economic outlook table below.

Table 1: US economic outlook table

		2015	2016	2017	2018	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18
GDP	% y/y	**2.6**	**1.6**	**2.4**	**2.9**	1.6	1.3	1.6	1.9	2.3	2.5	2.4	2.5	2.7	2.8	3.0	3.0
	% q/q					0.2	0.4	0.8	0.6	0.5	0.6	0.6	0.7	0.8	0.7	0.7	0.7
	%q/q ann.					0.8	1.4	3.2	2.4	2.1	2.4	2.5	2.8	3.1	3.0	2.9	2.9
Private Consumption	% y/y	**3.2**	**2.6**	**2.6**	**2.7**	2.4	2.7	2.7	2.7	2.9	2.4	2.4	2.6	2.7	2.7	2.7	2.6
	% q/q					0.4	1.1	0.7	0.5	0.6	0.6	0.7	0.7	0.7	0.6	0.6	0.6
Residential Investment	% y/y	**11.7**	**4.6**	**2.2**	**4.8**	11.7	5.7	1.5	0.3	-0.6	2.0	3.9	3.4	3.7	4.6	5.3	5.6
	% q/q					1.9	-2.0	-1.1	1.6	1.0	0.5	0.7	1.2	1.3	1.3	1.4	1.5
Non-Residential Investment	% y/y	**2.1**	**-0.5**	**3.6**	**6.3**	-0.4	-0.5	-1.4	0.4	2.1	3.0	4.4	4.9	5.7	6.2	6.5	6.7
	% q/q					-0.9	0.2	0.0	1.0	0.8	1.1	1.4	1.5	1.6	1.6	1.7	1.7
Government Spending	% y/y	**1.8**	**0.8**	**0.9**	**2.5**	1.9	0.7	0.3	0.3	0.2	0.9	1.2	1.3	1.8	2.3	2.8	3.2
	% q/q					0.4	-0.4	0.1	0.3	0.3	0.3	0.3	0.4	0.8	0.8	0.8	0.8
Final Dom Demand [1]	% y/y	**3.1**	**2.0**	**2.4**	**3.2**	2.2	2.0	1.7	1.9	2.2	2.2	2.5	2.7	3.0	3.2	3.3	3.3
	% q/q					0.3	0.6	0.4	0.6	0.6	0.6	0.7	0.8	0.9	0.8	0.8	0.8
Net Exports [1]	% y/y	**-0.7**	**0.0**	**-0.1**	**-0.4**	-0.3	-0.2	0.2	0.2	0.1	0.1	-0.3	-0.3	-0.4	-0.4	-0.4	-0.5
	% q/q					0.0	0.0	0.2	0.0	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Stockbuilding [1,5]	% y/y	**0.2**	**-0.4**	**0.0**	**0.0**	-0.1	-0.3	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Nominal GDP	% y/y	**3.7**	**2.9**	**4.6**	**5.3**	2.8	2.5	2.7	3.6	4.3	4.7	4.7	4.8	5.1	5.2	5.4	5.6
Current Account Balance	USD bn	**-463**	**-435**	**-448**	**-505**	-113	-112	-104	-106	-109	-110	-113	-116	-121	-124	-128	-132
	% of GDP	**-2.6**	**-2.3**	**-2.3**	**-2.5**	-2.5	-2.4	-2.2	-2.2	-2.3	-2.3	-2.3	-2.3	-2.4	-2.4	-2.5	-2.5
Industrial Production [2]	% y/y	**0.3**	**-0.9**	**1.8**	**3.1**	-1.6	-1.1	-1.0	0.0	0.9	1.7	2.0	2.6	3.0	3.2	3.1	2.9
	% q/q					-0.4	-0.2	0.4	0.2	0.5	0.6	0.7	0.8	0.9	0.7	0.6	0.6
Unemployment Rate [2]	%	**5.3**	**4.9**	**4.7**	**4.5**	4.9	4.9	4.9	4.9	4.8	4.7	4.7	4.6	4.6	4.6	4.5	4.5
CPI [2]	% y/y	**0.1**	**1.2**	**2.2**	**2.4**	1.1	1.1	1.1	1.7	2.0	2.1	2.3	2.3	2.3	2.3	2.4	2.5
Core PCE [2]	% y/y	**1.4**	**1.7**	**1.9**	**2.1**	1.6	1.6	1.7	1.8	1.8	1.8	1.9	1.9	2.0	2.0	2.1	2.2
Federal Govt. Balance [3,6]	% of GDP	**-2.4**	**-3.0**	**-3.2**	**-3.6**												
General Govt. Debt	% of GDP	**101.5**	**101.7**	**100.4**	**98.9**												
Fed Funds Rate [4]	**%**	**0.50**	**0.75**	**1.25**	**1.75**	0.50	0.50	0.50	0.75	0.75	1.00	1.25	1.50	1.50	1.75	1.75	2.00

[1] Contribution to GDP growth [2] Period averages [3] Federal budget balance [4] End of period
[5] Annual data refers to yoy change and quarterly data refers to qoq change
[6] Differs from Maastricht definition used for European countries. Under Maastricht, the balance would be -4.4% in 2015 and -4.6% in 2016 (EU Commission)
Source: Bureau of Economic Analysis and Berenberg Capital Markets

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Contacts: BCM

www.berenberg.com
e-mail US: firstname.lastname@berenberg-us.com

BERENBERG CAPITAL MARKETS

JOH. BERENBERG, GOSSLER & CO. KG — Internet www.berenberg.com — E-mail: firstname.lastname@berenberg.com

EQUITY RESEARCH

AEROSPACE & DEFENCE
Andrew Gollan +44 20 3207 7891
Charlotte Keyworth +44 20 3753 3013
Ross Law +44 20 3465 2692

AUTOMOTIVES
Adam Hull +44 20 3465 2749
Paul Kratz +44 20 3465 2678

BANKS
Adam Barrass +44 20 3207 7923
James Burbridge +44 20 3753 3014
James Chappell +44 20 3207 7844
Andrew Lowe +44 20 3465 2743
Eoin Mullany +44 20 3207 7854
Peter Richardson +44 20 3465 2681
Jonathan Sharpe +44 20 3753 3031

BEVERAGES
Javier Gonzalez Lastra +44 20 3465 2719
Batuhan Karabekir (EM) +44 20 3465 2631
Adam Mizrahi +44 20 3465 2653

BUSINESS SERVICES, LEISURE & TRANSPORT
Roberta Ciaccia +44 20 3207 7805
Najet El Kassir +44 20 3207 7836
Stuart Gordon +44 20 3207 7858
Simon Mezzanotte +44 20 3207 7917
Josh Puddle +44 20 3207 7881

CAPITAL GOODS
Sebastian Kuenne +44 20 3207 7856
Philippe Lorrain +44 20 3207 7823
Rizk Maidi +44 20 3207 7806
Horace Tam +44 20 3465 2726
Simon Toennessen +44 20 3207 7819

CHEMICALS
Sebastian Bray +44 20 3753 3011
Andrew Heap +44 20 3207 7918
John Klein +44 20 3207 7930

CONSTRUCTION
Lush Mahendrarajah +44 20 3207 7896
Robert Muir +44 20 3207 7860
Olivia Peters +44 20 3465 2646
Michael Watts +44 20 3207 7928

ENERGY
Yuriy Kukhtanych (EM) +44 20 3465 2675

FOOD MANUFACTURING AND H&PC
Yordana Mavrodieva +44 20 3207 7817
Fintan Ryan +44 20 3465 2748
James Targett +44 20 3207 7873

FOOD RETAIL
Batuhan Karabekir (EM) +44 20 3465 2631

GENERAL MID CAP - EU
Gunnar Cohrs +44 20 3207 7894
Martin Comtesse +44 20 3207 7878
Flavien Hias +44 20 3465 2693
Anna Patrice +44 20 3207 7863
Benjamin Pfannes-Varrow +44 20 3465 2620
Simona Sarli +44 20 3207 7834
Julia Scheufler +44 20 3753 3016

GENERAL MID CAP - UK
Robert Chantry +44 20 3207 7861
Sam England +44 20 3465 2687
Ned Hammond +44 20 3753 3017
Benjamin May +44 20 3465 2667
Owen Shirley +44 20 3465 2731

GENERAL RETAIL
Conrad Bartos +44 20 3753 3053
Michelle Wilson +44 20 3465 2663

HEALTHCARE
Scott Bardo +44 20 3207 7869
Jakob Berry +44 20 3465 2724
Alistair Campbell +44 20 3207 7876
Graham Doyle +44 20 3465 2634
Klara Fernandes +44 20 3465 2718
Tom Jones +44 20 3207 7877
Louise Pearson +44 20 3465 2747
Laura Sutcliffe +44 20 3465 2669

INSURANCE
Trevor Moss +44 20 3207 7893
Emanuele Musio +44 20 3207 7916
Iain Pearce +44 20 3465 2665
Sami Taipalus +44 20 3207 7866

LUXURY GOODS
Zuzanna Pusz +44 20 3207 7812

MEDIA
Robert Berg +44 20 3465 2680
Laura Janssens +44 20 3465 2639
Alastair Reid +44 20 3207 7841
Sarah Simon +44 20 3207 7830

METALS & MINING
Alessandro Abate +44 20 3753 3029
Fawzi Hanano +44 20 3207 7910
Yuriy Vlasov +44 20 3465 2674

REAL ESTATE
Kai Klose +44 20 3207 7888
Tina Munda +44 20 3465 2716

TECHNOLOGY
Jean Beaubois +44 20 3207 7835
Georgios Kertsos +44 20 3465 2715
Gal Munda +44 20 3465 2746
Tammy Qiu +44 20 3465 2673

TELECOMMUNICATIONS
Ondrej Cabejsek (EM) +44 20 3753 3071
Usman Ghazi +44 20 3207 7824
Siyi He +44 20 3465 2697
Laura Janssens +44 20 3465 2639
Paul Marsch +44 20 3207 7857
Michael Summerville +44 20 3207 7914

THEMATIC RESEARCH
Nick Anderson +44 20 3207 7838
Asad Farid +44 20 3207 7932

TOBACCO
Jonathan Leinster +44 20 3465 2645

UTILITIES
Robin Abrams +44 20 3465 2635
Andrew Fisher +44 20 3207 7937
Lawson Steele +44 20 3207 7887

ECONOMICS
Florian Hense +44 20 3207 7859
Carsten Hesse (EM) +44 20 3753 3001
Kallum Pickering +44 20 3465 2672
Holger Schmieding +44 20 3207 7889

EQUITY SALES

SPECIALIST SALES

AEROSPACE & DEFENCE
Bruna Zugliani +44 20 3207 7818
AUTOMOTIVE & THEMATICS
Chris Armstrong +44 20 3207 7809
BANKS & DIVERSIFIED FINANCIALS
Iro Papadopoulou +44 20 3207 7924
CONSUMER STAPLES
Rupert Trotter +44 20 3207 7815
CONSUMER DISCRETIONARY
Victoria Maigrot +44 20 3753 3010
HEALTHCARE
Frazer Hall +44 20 3207 7875
MEDIA & TELECOMMUNICATIONS
Julia Thannheiser +44 20 3465 2676
SPECIAL SITUATIONS
Jeremy Grant +44 20 3207 7890

SALES

BENELUX
Miel Bakker +44 20 3207 7808
Martin de Laet +44 20 3207 7804
Alexander Wace +44 20 3465 2670

GERMANY
Michael Brauburger +49 69 91 30 90 741
Nina Buechs +49 69 91 30 90 735
André Grosskurth +49 69 91 30 90 734
Florian Peter +49 69 91 30 90 740
Joerg Wenzel +49 69 91 30 90 743

UK
Alexandra Clément +44 20 3753 3018
Fabian De Smet +44 20 3207 7810
Toby Flaux +44 20 3465 2745
Karl Hancock +44 20 3207 7803
Sean Heath +44 20 3465 2742
David Hogg +44 20 3465 2628
Peter Kaineder +44 20 3753 3062
James Matthews +44 20 3207 7807
David Mortlock +44 20 3207 7850
Eleni Papoula +44 20 3465 2741
Bhavin Patel +44 20 3207 7926
Richard Payman +44 20 3207 7825
Joanna Sanders +44 20 3207 7925
George Smibert +44 20 3207 7911
Anita Surana +44 20 3207 7855
Paul Walker +44 20 3465 2632

FRANCE
Thibault Bourgeat +33 1 5844 9505
Alexandre Chevassus +33 1 5844 9512
Dalila Farigoule +33 1 5844 9510
Clémence Peyraud +33 1 5844 9521
Benjamin Voisin +33 1 5844 9507

SWITZERLAND, AUSTRIA & ITALY
Andrea Ferrari +41 44 283 2020
Carsten Kinder +41 44 283 2024
Gianni Lavigna +41 44 283 2038
Jamie Nettleton +41 44 283 2026
Benjamin Stillfried +41 44 283 2033

SCANDINAVIA
Frederik Angel +44 20 3753 3055
Marco Weiss +49 40 350 60 719

CRM
Jessica Jarmyn +44 20 3465 2696
Edwina Lucas +44 20 3207 7908
Greg Swallow +44 20 3207 7833

CORPORATE ACCESS
Lindsay Arnold +44 20 3207 7821
Jennie Jiricny +44 20 3207 7886
Stella Siggins +44 20 3465 2630

EVENTS
Laura Hawes +44 20 3753 3008
Suzy Khan +44 20 3207 7915
Charlotte Kilby +44 20 3207 7832
Natalie Meech +44 20 3207 7831
Ellen Parker +44 20 3465 2684
Sarah Weyman +44 20 3207 7801

SALES TRADING

HAMBURG
Tim Storm +49 40 350 60 415

PARIS
Vincent Klein +33 1 58 44 95 09
Antonio Scuotto +33 1 58 44 95 03

LONDON
Mike Berry +44 20 3465 2755
Stewart Cook +44 20 3465 2752
Mark Edwards +44 20 3753 3004
Tristan Hedley +44 20 3753 3006
Peter King +44 20 3753 3139
Christoph Kleinasser +44 20 3753 3063
Chris McKeand +44 20 3207 7938
Simon Messman +44 20 3465 2754
AJ Pulleyn +44 20 3465 2756
Paul Somers +44 20 3465 2753

EQUITY TRADING

HAMBURG
David Hohn +49 40 350 60 761
Gregor Labahn +49 40 350 60 571
Lennart Pleus +49 40 350 60 596
Marvin Schweden +49 40 350 60 576
Linus Weidner +49 40 350 60 798
Philipp Wiechmann +49 40 350 60 346
Christoffer Winter +49 40 350 60 559

LONDON
Edward Burlison-Rush +44 20 3753 3055
Richard Kenny +44 20 3753 3083

ELECTRONIC TRADING
Daniel Eichhorn +49 40 350 60 391
Matthias Führer +49 40 350 60 597

BERENBERG CAPITAL MARKETS LLC Member FINRA & SIPC — E-mail: firstname.lastname@berenberg-us.com

EQUITY SALES

SALES
Kelleigh Faldi +1 617 292 8288
Isabella Fantini +1 646 445 4861
Shawna Giust +1 646 445 7216
Rich Harb +1 617 292 8228
Zubin Hubner +1 646 445 5572
Jessica London +1 646 445 7218
Ryan McDonnell +1 646 445 7214
Emily Mouret +1 415 802 2525
Peter Nichols +1 646 445 7204
Kieran O'Sullivan +1 617 292 8292

CRM
Laura Cooper +1 646 445 7201

CORPORATE ACCESS
Olivia Lee +1 646 445 7212

EVENTS
Patricia Ehrhart +1 646 445 4863

SALES TRADING
Scott Duxbury +1 646 445 5573
Christopher Kanian +1 646 445 5576
Lars Schwartau +1 646 445 5571
Bob Spillane +1 646 445 5574

ECONOMICS
Mickey Levy +1 646 445 4842